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Kimberly M. Kirby
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Federal Communications Commission
Office of Secretary

EX PARTE

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April 30, 1997

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, NW Room 222
Washington, DC 20554

Re: Ex Parte Presentation in CC Docket No. 96-262 and CC Docket No. 96-45

Dear Mr. Caton:

On Wednesday, April 30, 1997, Jonathan Sallet, Chief Policy Counsel of MCI, Michael Pelcovits, Chief Economist of MCI, Chris Frentrup of MCI, and Joel Lubin of AT&T met with Commissioner Chong and Dan Gonzalez, Legal Advisor to Commissioner Chong. The purpose of the meeting was to discuss (1) the legal justifications for resetting the productivity factor and applying it to past years; (2) the mechanisms the FCC should use to reduce access charges; and (3) how the FCC can ensure the neutrality and portability of universal service support. The attached document, filed as part of the record in the above captioned proceedings on Tuesday, April 29, 1997, details the topics discussed.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(2) of the Commission's rules.

Sincerely,

Kimberly M. Kirby

Kimberly M. Kirby

Attachment

cc: Commissioner Chong (Letter Only)
Dan Gonzalez (Letter Only)

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April 29, 1997

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, NW Room 222
Washington, DC 20554

Re: Ex Parte Presentation in CC Docket No. 96-262 and CC Docket No. 96-45

Dear Mr. Caton:

Please file the enclosed letter and attachments as part of the record in the above-captioned proceedings. This information is in response to a request from Chairman Hundt and therefore will not count against MCI's page limit.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

Kimberly M. Kirby

Kimberly M. Kirby

Attachments

cc: Commissioner Chong
Commissioner Ness
Commissioner Quello
Regina Keeney
William Kennard
Greg Rosston
Larry Atlas
Richard Metzger
John Nakahata
Kathy Levitz
Suzanne Tetreault

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Jonathan B. Sallet
Chief Policy Counsel

April 29, 1997

The Honorable Reed E. Hundt, Chairman
Federal Communications Commission
1919 M Street NW
Washington, DC 20554

Re: Ex Parte Presentation in CC Docket No. 96-262 and CC Docket No. 96-45

Dear Mr. Chairman:

In response to your request, we are answering three specific questions that you posed during our meeting on Monday, April 28, 1997. As you know, we remain opposed to any access charge reform plan that fails to lower the telephone rates of American consumers and businesses because, as we have explained, the current access charge system pays billions of dollars of unjustified subsidies to incumbent telephone companies. The record in this proceeding shows this beyond dispute. We also oppose any universal service proposal that fails to meet the congressional command that all subsidies for the support of affordable telephone service be made explicit immediately. Thus, while responding to your request, we want to be careful to note that we are not addressing other issues under consideration by the Federal Communications Commission ("FCC" or "Commission") whose resolution, we believe, is mandated by law.

I. What is the legal basis for resetting the productivity factor and applying it to past years?

The FCC, in its Interim Price Cap Order,[1] found that existing price cap mechanisms unreasonably shifted the balance of ratepayer and ILEC shareholder interests in favor of the ILECs. The FCC stated that a one-time reduction in ILEC Price Cap Indices was required to correct, on a prospective basis, the effects of the FCC's underestimation of LEC productivity. The FCC explained that correct specification of the productivity factor was a critical element in the balance the FCC struck between ratepayer and ILEC shareholder interests when it instituted price cap regulation.[2]

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[1] In the Matter of: Price Cap Performance Review for Local Exchange Carriers, CC Docket 94-1, released April 7, 1995 ("1995 Price Cap Order").

[2] 1995 Price Cap Order at ¶¶ 245, 246.

There is a sufficient record for the FCC to adjust the productivity factor today and apply it starting from any year since 1990; a practice the Commission followed in the interim price cap order in 1995.[3] This is also consistent with recent comments submitted by the Department of Justice (see attachment) and NTIA (see attachment).

The productivity adjustment is intended to be an incentive to the ILECs to become more efficient. The current price cap, with its low productivity adjustments, provides no challenge for increased ILEC efficiency. Studies were placed in the price cap docket by AT&T, Ad Hoc and CARE which indicate true ILEC productivity is as much as 10%. The continuing trend of increased earnings demonstrate that even with the modest increases in the X factor in the interim order, the price cap is not now properly calibrated to yield a reasonable return or emulate the competitive market. Only an adjustment to the 8-10% level will yield results that accord with the purposes and objectives of the price cap procedures.

MCI recently filed an analysis of ILEC earnings as an ex parte presentation, which indicates the appropriate productivity adjustment would fall between 7.95% and 10.63%. This ILEC productivity analysis is filed in response to a flawed analysis submitted by USTA in Attachment 7 of its access reform comments which purports to show unbelievably low ILEC productivity.

II. What mechanism should the FCC use to determine whether any reliance on market mechanisms to reduce access charges is working, and, if not, to mandate additional reductions?

The end-game of any reduction in access charges should be economic cost, i.e., TELRIC-based access charges. There is abundant evidence that this will result in substantial cuts in access charges. For example, the Consumer/Business coalition proposal requires an overall cut in switched access charges of at least $10.5 billion over five years to drive access prices to TELRIC. The current price cap plan, on the other hand, forces rate cuts of, at most, inflation minus 5.3 percent, which at current expected rates of inflation would reduce access charges by about $550 million per year. At this rate, access charges would not reduced to economic cost for nineteen years.

It is important that the Commission adopt specific, enforceable mechanisms to ensure that

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[3] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990); See also1995 Price Cap Order; See also Ex Parte Letter dated April 23, 1997 to William F. Caton from Brad Stillman, Senior Counsel of MCI (attached); See also Ex Parte Letter dated April 18, 1997, to William F. Caton from Chris Frentrup, Senior Regulatory Analyst for MCI (attached); See also 1995 Price Cap Order at ¶ 248.

the expected access reductions are, in fact, achieved. The following two methods may be responsive to your inquiry, consistent with the conditions you set forth:

First, the Commission must determine the economic cost of access charges through a study it would complete this year. This study would then serve as the benchmark for comparison with LEC access reductions. The Commission would mandate the appropriate reduction each year.

Starting July 1, 1998, the Commission would assess whether there has been the movement toward TELRIC rates that would be expected if access charges were to reach cost by July 1, 2002. If the reduction were less than the linear reduction expected each year, a prescriptive reduction would be ordered.

Second, it is critical that the FCC enforce the mechanisms necessary to permit vibrant market operation. Thus, failure of an ILEC to meet the performance standards, service quality measurements, and other terms and conditions governing access to unbundled network elements, including collocation and access to fully operational support systems, as set forth in its Section 252 agreements, should result in a suspension of the flat fees created by the access restructuring order in the geographic area governed by the agreements until such a time as the ILEC requirements were met. The flat fees would contain, by definition, surplus funds that cannot be justified by the cost of access or the needs of the universal service fund.

This additional trigger would serve to remind the ILECs that failure to provide OSS and other market-opening requirements immediately limit their recovery of access revenues. Absent such a method, use of a market-based approach would fail to create any incentives for ILEC actions to open the local market.

Use of these triggers would be consistent with the recent proposals by the Department of Justice and the NTIA, both of which urged the use of a prescriptive approach if access rates were not reduced by competition. As these two agencies recognized, the development and strength of competition as a means of ensuring access reductions is, at best, unclear. Thus, the Commission must adopt a mandatory approach to reduce access charges to protect ratepayers. Use of the triggers outlined above would help provide ratepayers the protection they need to achieve access rate reductions.

III. <u>How may the FCC move quickly to ensure the neutrality and portability of universal service support?</u>

The Commission can move quickly to ensure the neutrality and portability of universal service support by moving funds identified in this proceeding as providing universal service support into a competitively neutral and explicit federal fund, until support can be determined based on a forward-looking cost proxy model. Section 254(b)(4) and (5) of the Telecommunications Act of 1996 ("Act") require it, and it is easily accomplished.

Based on the record in this proceeding, at least $5.7 billion in existing mechanisms fund universal service. There is no dispute that the current Universal Service Fund (high cost assistance fund), triple DEM weighting, and Long Term Support, which total approximately $1.51 billion annually, fund universal service. In addition, approximately $180 million is collected annually to fund Lifeline and Link-Up for low income consumers. All of these programs should and can be funded through the new and explicit federal universal service fund.

The record also supports a finding that a portion of access charges, in addition to Long Term Support, represents implicit funding for universal service. For example, in a joint filing, BellSouth Corporation, Pacific Telesis Group and SBC Telecommunications state that $4 billion in implicit universal service support is currently contained in switched access charges.[4] Thus, this $4 billion may be immediately removed from access charges and "replaced" by an interim $4 billion universal service fund, to operate until a final judgment on the size of universal service is made and all universal service subsidies are removed from access charges. Failure to make explicit those sums that are now recognized to constitute universal service support would violate the Act and would deprive new entrants providing service to a ratepayer eligible for universal service of the support that Congress intended to be immediately available.

Sincerely,

Jonathan B. Sallet
Chief Policy Counsel

Attachments

cc: Commissioner Chong
Commissioner Ness
Commissioner Quello
Regina Keeney
William Kennard
Greg Rosston

Larry Atlas
Richard Metzger
John Nakahata
Kathy Levitz
Suzanne Tetreault

[4] See, Ex Parte Letter dated April 15, 1997 to The Honorable Reed E. Hundt from David J. Markey of BellSouth Corporation, Thomas O. Moulton, Jr. of Pacific Telesis Group and Dale "Zeke" Robertson of SBC Telecommunications, Inc. at 3. See also, Ex Parte letter dated April 16, 1997 to the Honorable Reed E. Hundt from Bruce K. Posey of US West, Inc., at 2.